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No. 91-1135

IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.
as successor to The Herald Company,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the Petitioner, Newark Morning Ledger Co.[1] Tax Executives Institute (herein-

[1] Tax Executives Institute has received the written consents of the Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

after "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently represents more than 4,800 members who are employed by 2,000 of the leading corporations in the United States and Canada. The members of the Institute represent a cross-section of the business community in North America.

TEI is dedicated to promoting the uniform, systematic, and equitable interpretation and enforcement of the tax laws. It is also dedicated to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers. This case implicates fundamental questions concerning the tax treatment of acquired intangible property. TEI is concerned about the potential effect of the Third Circuit's flawed opinion on the ability of taxpayers to depreciate the intangible wasting assets that are used in their businesses. As the individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

This case involves whether a newspaper's paid subscribers acquired by purchase and having a limited useful life may be depreciated for federal income tax purposes. The outcome turns on whether an intangible asset has an ascertainable value and a useful life separate and distinct from goodwill.

Section 1.167(a)-3 of the Income Tax Regulations sets forth a fact-based standard for determining whether an asset may be depreciated: (1) does the intangible asset have a limited useful life?, and (2) if so, can that useful life be estimated with reasonable accuracy? The regulations do not, however, permit a deduction for goodwill. Although the regulations do not define that term, the

courts have filled the gap by defining goodwill to be the expectancy that "old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) (citing *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962)), and "the expectancy of continued patronage, for whatever reason." *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). Thus, "goodwill" may be fairly equated with "good name" —that is to say, the ephemeral aura that surrounds a viable business until some event intervenes to reduce or eliminate it.

In the landmark case of *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), the court reasoned that early cases denying a current depreciation deduction had generally turned on the failure of the taxpayer to prove its case. The court held that under the Internal Revenue Code an intangible asset—including a customer-based intangible—may be depreciated if the taxpayer satisfies a two-prong test: (1) the intangible has an ascertainable cost basis separate and distinct from goodwill and going concern value, and (2) the intangible has a limited useful life. *Id.* at 1251. Since that time, the courts have generally agreed that depreciability of a particular intangible asset is a question of fact.

In this case, the taxpayer unquestionably demonstrated that the customer-based intangible here at issue—the newspaper's paid subscribers—had an ascertainable value separate and distinct from goodwill and a limited useful life. The United States Court of Appeals for the Third Circuit conceded as much, but averred that "there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable."

The Third Circuit's opinion is wrong. Under the case law, a depreciation deduction is not denied because an intangible is called "goodwill"; rather, it is denied because the intangible does not have a determinable useful life or value. Obversely, if an intangible asset has an ascertainable value and a limited useful life, it is—by definition—separate and distinct from goodwill and may be depreciated under section 167(a) of the Code. The label is not controlling, the facts are.

The legal standard propounded by the Third Circuit would imprison taxpayers in the straitjacket of nondeductibility. Such a result would not only be at odds with the statute, but would deny taxpayers the benefit of modern valuation methodologies. Hence, although taxpayers in earlier cases may have been unable to sustain their factual burden under the regulations, the refinement of valuation and measurement techniques has undeniably enabled taxpayers in appropriate cases to meet their burden. As the District Court found, the taxpayer both proved the separate and distinct value of the customer-based intangible here in issue and reasonably estimated its useful life. There is no principle of tax law or precept of tax administration that justifies denying a depreciation deduction.

Moreover, the Third Circuit's rejection of the residual method of valuation flouts Congress's express determination that such a method is a legitimate means of valuing tangible and intangible assets. In section 1060 of the Code, Congress mandated the use of the residual method for allocating the consideration paid among the assets—including intangible assets—conveyed in certain acquisitions. Congressional endorsement of the valuation method underscores the flawed nature of the Third Circuit's logic.

As the Court recognized earlier this term in *Indopco, Inc. v. Commissioner*, 60 U.S.L.W. 4173 (U.S. Feb. 26, 1992) (No. 90-1278), "the Code endeavors to match expenses with the revenues of the taxable period to which

they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *Id.* at 4174 (citing *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974), and *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983). The Third Circuit facilely rejects this fundamental matching principle by effectively precluding the taxpayer from recovering its costs over the useful life of the affected assets. The court's opinion is therefore wrong as a matter of sound tax policy.

Finally, the Third Circuit's decision marks a radical departure in the legal principles employed in determining the depreciability of customer-based intangibles. *Amicus* TEI respectfully suggests that if the tax treatment of customer-based intangibles is to be so fundamentally changed, it is for Congress to decide. Contrary to the Third Circuit's decision, Congress has not stood mute on this issue. Rather, it has specifically chosen not to act. That the Third Circuit would judicially legislate a new rule is wholly improper. "If the [taxpayer] has found a hole in the tax dike, the problem must be corrected by applying the thumb of Congress, not the Court's." *Apple Computer, Inc. v. Commissioner*, 98 T.C. No. 18 (Dkt. No. 34127-87), at n.4 (1992), *reprinted in* [1992] Tax Ct. Rep. (CCH) 4759, 4762 n.4 (citing *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876, 879 (1st Cir. 1961)).

The decision of the U.S. Court of Appeals for the Third Circuit should be reversed.

ARGUMENT

I. CUSTOMER-BASED INTANGIBLES MAY BE DEPRECIATED

This case involves whether intangible property acquired by purchase and having a limited useful life may be depreciated under the Internal Revenue Code. The resolution of this issue turns on whether an intangible asset (such as the paid subscribers at issue here) has an ascertainable value and a useful life separate and distinct from goodwill. Applying the statutory and regulatory provisions, the District Court found that the taxpayer had sustained its burden of proof. (App. 32a.)[2] The United States Court of Appeals for the Third Circuit, however, denied the dispositive nature of the taxpayer's uncontroverted factual showing and reversed the District Court on the ground that, as a matter of law, the intangible property was an integral part of goodwill and therefore non-depreciable. (App. 28a-29a.) *Amicus* TEI submits that the Third Circuit's opinion is fundamentally wrong.

Consistent with the basic principles of a net income tax, the Internal Revenue Code affords taxpayers a deduction for ordinary and necessary expenses incurred in carrying on any trade or business. Taxpayers are not, however, customarily permitted to deduct currently the costs associated with acquiring capital assets whose useful lives extend beyond the end of the taxable year. These expenditures must be capitalized and depreciated or amortized over the life of the asset or, if no specific useful life can be ascertained, upon the disposition of the asset (through sale or abandonment) or the dissolution of the enterprise. 26 U.S.C. §§ 167(a), 336(a) [hereinafter cited as "I.R.C." or "the Code"]; *Indopco, Inc. v. Commissioner*, 60 U.S.L.W. 4173, 4174 (U.S. Feb. 26, 1992) (No. 90-1278).[3]

[2] References to "App." are to the appendix filed with Newark Morning Ledger Co.'s Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

The current rule for depreciating intangible assets is set forth in section 1.167(a)-3 of the Treasury Department's Income Tax Regulations:[4]

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

Thus, the regulations set forth a fact-based standard: (1) does the intangible asset have a limited useful life?, and (2) if so, can that useful life be estimated with reasonable accuracy?[5] If the taxpayer can answer the two

[3] The deduction for depreciation was first enacted by the Revenue Act of 1913 which provided a reasonable allowance for "wear and tear of property arising out of its use or employment in the business." Revenue Act of 1913, 38 Stat. 114, 167. The term "depreciation" is generally used with respect to tangible property; the term "amortization" is generally used in reference to intangible assets. Stanley S. Surrey, Paul R. McDaniel, Hugh J. Ault & Stanley A. Koppelman, *Federal Income Taxation* 464 n.13 (Successor ed. 1986). To avoid confusion, the term "depreciation" is used hereinafter to refer to both depreciation and amortization.

[4] Provisions of the Income Tax Regulations (26 C.F.R.) are hereinafter cited as "Treas. Reg. §." Provisions of temporary income tax regulations are cited as "Temp. Regs. §."

[5] The courts have accorded taxpayers substantial flexibility in estimating the useful lives of both tangible and intangible assets. *See, e.g., Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1253-54 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129

questions affirmatively, a depreciation deduction will be allowed; if the facts cannot be marshalled to so answer the questions, a current deduction is not permitted.

The regulatory disallowance of a depreciation deduction for "goodwill"—set forth in the last sentence of the quoted language—has been virtually unchanged since its promulgation in 1927.[6] This is not to say, however, that no question exists about the relationship between the disallowance and the core rule that intangibles may be depreciated. The issue turns on the scope of the term "goodwill," which the regulations themselves do not define. Courts, however, have defined the term for tax purposes to be the expectancy that "old customers will resort to the old place," *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) (citing *Nelson Weaver Realty Co. v. Commissioner*, 307 F.2d 897, 901 (5th Cir. 1962)), and "the expectancy of continued patronage, for whatever reason." *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962). Thus, "goodwill" may be fairly equated with "good name"—that is to say, the ephemeral aura that surrounds a viable business until some event intervenes to reduce or eliminate it.

Several early cases denied taxpayers a deduction for customer-based intangibles, essentially on the grounds that the taxpayers had failed to sustain their factual burden under the regulations of distinguishing the intangible

(1974) ("Extreme exactitude in ascertaining the duration of an asset is a paradigm that the law does not demand. All that the law and regulations require is reasonable accuracy in forecasting the asset's useful life."); *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284, 298 (1983) (requiring only "reasonable predictions of probable future developments").

[6] Article 163 of Treasury Regulations 69 generally provided that intangible assets were depreciable if they had a limited useful life. The regulation stated that "[n]o deduction for depreciation, including obsolescence, is allowable in respect of good will." T.D. 4055, VI-2 C.B. 63 (Aug. 4, 1927).

from goodwill. *See, e.g., Golden State Towel & Linen Serv. v. United States*, 373 F.2d 938, 941 (Ct. Cl. 1967) (terminable-at-will customer list is indivisible from goodwill and therefore non-depreciable); *Winn-Dixie Montgomery, Inc. v. United States*, 444 F.2d 677, 681 (5th Cir. 1971) (leaseholds possess same qualities as goodwill, have no ascertainable useful lives, and are self-regenerating). These cases applied a "mass asset" rule pursuant to which arguably distinct assets were deemed to be "inextricably" linked to goodwill. In 1973, however, this juridic shorthand was rejected by the Fifth Circuit, which held in *Houston Chronicle Publishing Co. v. United States*, 481 F.2d 1240, 1249-50 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974), that the mass asset rule did not "establish a *per se* rule of non-amortizability in every case involving both goodwill and other intangible assets." Reasoning that these early cases turned on the failure of the taxpayer to prove its case, the court concluded that under the regulations an intangible asset—including a customer-based intangible—may be depreciated if the taxpayer satisfies a two-prong test: (1) the intangible has an ascertainable value separate and distinct from goodwill and going concern value;[7] and (2) the intangible has a limited useful life. *Id.* at 1251.

Since the *Houston Chronicle* case, the courts have generally agreed that whether an intangible asset is depreciable is a question of fact. *Citizens & Southern Corp. v. Commissioner*, 91 T.C. 463, 479 (1988), *aff'd per*

[7] "Going concern value" has been defined as "the additional element of value which attaches to property by reason of its existence as an integral part of a going concern." *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989) (quoting *VGS Corp. v. Commissioner*, 68 T.C. 563, 591 (1977), *acq.*, 1979-1 C.B. 1). Although the distinction between goodwill and going concern value is often blurred by the courts, the tax law treats both intangibles as nondepreciable assets. *VGS Corp.*, 68 T.C. at 592; *Illinois Cereal Mills v. Commissioner*, 46 T.C.M. (CCH) 1001, 1023 (1983), *aff'd on other grounds*, 789 F.2d 1234 (7th Cir.), *cert. denied*, 479 U.S. 995 (1986).

curiam, 919 F.2d 1492 (11th Cir. 1990); *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988); *Donrey, Inc. v. United States*, 809 F.2d 534, 536 (8th Cir. 1987); *Banc One Corp. v. Commissioner*, 84 T.C. 476, 492 (1985), *aff'd*, 815 F.2d 75 (6th Cir. 1987); *Liquid Paper Corp. v. United States*, 2 Cl. Ct. 284, 297 (1983); *Los Angeles Central Animal Hosp. v. Commissioner*, 68 T.C. 269, 273 (1977), *acq.*, 1978-1 C.B. 1; and *Computing & Software, Inc. v. Commissioner*, 64 T.C. 223, 232 (1975), *acq.*, 1976-1 C.B. 1. *See also* Stanley S. Surrey, Paul R. McDaniel, Hugh J. Ault & Stanley A. Koppelman, *Federal Income Taxation* 480 (Successor ed. 1986) ("This [mass asset] approach was rejected by the courts, which held that the issue in such cases was one of fact.").[8]

That an intangible asset—including a customer-based intangible—may be subject to depreciation was conceded by the Internal Revenue Service (IRS) itself in the year following the *Houston Chronicle* decision. Rev. Rul. 74-456, 1974-2 C.B. 65. Clearly, the taxpayer has the burden of showing the fact and rate of depreciation with "reasonable certainty" or a "reasonable approximation," *Burnet v. Niagara Falls Brewing Co.*, 282 U.S. 648, 654-55 (1931), but one thing should be immutable: customer-based intangibles have a limited useful life and are therefore depreciable. *See Citizens & Southern Corp., supra*, & cases cited therein. As recently as three weeks ago, the new Chief Judge of the U.S. Tax Court confirmed the depreciability of such assets explicitly on the grounds that they are separate and distinct from goodwill. *See Peoples Bancorporation v. Commissioner*, T.C. Memo. 1992-285 (Dkt. No. 29058-89) (May 18, 1992) (Hamblen, J.) (core deposits of a bank are depreciable). Notwithstanding the clear consensus, the IRS has persisted in strictly applying Rev. Rul. 74-456 and challenging the depreciability of particular intangible assets on both legal and factual grounds.

[8] Only one court in the last 20 years has embraced the "mass asset" rule, and even there the court held that the issue involved a question of fact with respect to which the taxpayer had failed to meet its burden of proof. *AmSouth Bancorporation v. United States*, 681 F. Supp. 698, 712-13 (N.D. Ala. 1988).

In this case, the taxpayer unquestionably demonstrated that the customer-based intangible here at issue—the newspaper's paid subscribers—had an ascertainable value separate and distinct from goodwill and a limited useful life. Indeed, these facts were conceded by the government. (App. 9a, 32a.) Nevertheless, the Third Circuit—casting aside the language of the regulations and the teaching of established law—averred that "there are some intangible assets which, notwithstanding that they have wasting lives that can be estimated with reasonable accuracy and ascertainable values, are nonetheless goodwill and nondepreciable." (App. 29a.) The Third Circuit thus invoked the term "goodwill" as a shibboleth to deny the core rule in the regulations and to deprive taxpayers an opportunity to establish their entitlement to a deduction for wasting assets.

The Third Circuit's opinion is wrong as a matter of law. Under the case law, goodwill is not depreciable because it "has no determinable economic life apart from the business as a going concern. It ordinarily is *not* assignable apart from the business to which it applies. It continues in varying value as long as the business." *Dodge Bros v. United States*, 33 F. Supp. 312, 317 (D. Md. 1940), *aff'd*, 118 F.2d 95 (4th Cir. 1941) (emphasis in original). In contrast, an asset having a "determinable economic life apart from the business as a going concern" is *not* goodwill and, hence, not subject to the regulatory disallowance. As the Court of Claims succinctly held in 1976, "[t]he most significant indication that an intangible asset is separate and distinct from good will is whether its useful life can be shown with reasonable accuracy to be of limited duration." *Richard S. Miller & Sons v. United States*, 537 F.2d 446, 452

(Ct. Cl. 1976). *Cf. Illinois Cereal Mills v. Commissioner*, 46 T.C.M. (CCH) 1001, 1024 (1983), *aff'd on other grounds*, 789 F.2d 1234 (7th Cir. 1986), *cert. denied*, 479 U.S. 995 (1986) (goodwill is not subject to depreciation because its useful life is not suspectible of reasonable estimation); *Colorado Nat'l Bankshares v. Commissioner*, 60 T.C.M. (CCH) 771, 789 (1990) ("It is these characteristics [separate values and lives] which separate [the deposit accounts] from general goodwill and permit separate valuation."). Again, the issue is a factual question, not a legal one.

A recent report by the U.S. General Accounting Office summarized the evolution of the intangible asset depreciation rule, as follows:

> In 1927, the Department of the Treasury published regulations containing the first statement that goodwill is not amortizable. Goodwill was generally viewed as having an indeterminable useful life. Without a determinable useful life, there was no period over which to recover the asset's cost, and therefore, no deduction could be calculated or allowed under the statutory provision.

U.S. General Accounting Office, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (GAO/GGD-91-88) 18 (August 1991). Congress has likewise recognized that "because goodwill does not have a determinable useful life, no depreciation deduction is allowed with respect to that intangible asset." H.R. Rep. No. 495, 100th Cong., 1st Sess. 936 (1987) (Conference Report on the Omnibus Budget Reconciliation Act of 1987).

The Third Circuit's tautology notwithstanding, a depreciation deduction is not denied because an intangible is labelled "goodwill"; rather, it is denied because the intangible, whatever its label, has an indeterminate useful life. Obversely, if an intangible asset has an ascertainable value and a limited useful life, it is—by definition—separate and distinct from goodwill and may be depreciated under section 167(a) of the Code. The label is not controlling, the facts are.

The Third Circuit argued that because the intangible in this case contributed to continued patronage, it is, *ipse dixit*, indistinguishable from goodwill. (App. 10a-12a, 28a.) Such a standard, however, has been expressly rejected by other courts. *E.g., Citizens & Southern Corp.*, 91 T.C. at 481. Moreover, the court's reasoning is flawed because many expenses that are currently deductible undeniably contribute to continued patronage. For example, advertising is intended to build and sustain patronage, yet the expenses of advertising are deductible for tax purposes. Treas. Reg. § 1.162-1(a) (advertising and other selling expenses are generally deductible); Treas. Reg. § 1.162-20(a) (deduction allowed for institutional or goodwill advertising). If the Third Circuit's logic were carried to the extreme, as a matter of law *nothing* would be depreciable because virtually *all* business expenditures contribute in some way to continued patronage and goodwill. Such a result, of course, would eviscerate the core rule in the regulations and, indeed, section 167 itself.[9]

The legal standard propounded by the Third Circuit would imprison taxpayers in the straitjacket of nondeductibility. Such a result would not only be at odds with the statute, but would also deny taxpayers—and, indeed, the tax system—the benefit of modern valuation methodologies. Hence, although taxpayers in earlier cases may have been unable to sustain their factual burden under the regulations, the refinement of valuation and measurement techniques has enabled taxpayers to over-

[9] The Third Circuit's reasoning could easily be extended to the absurd. If "contribution to continuing patronage" is the standard, it should then apply with equal vigor to both tangible and intangible property. Thus, an efficient machine producing superior products or a structure attractive to customers would fail the depreciability test simply because it enhances customer patronage.

come their burden. As the District Court found—and neither the government nor the Third Circuit disputed—the taxpayer in this case both proved the separate and distinct value of the customer-based intangible here in issue and reasonably estimated its useful life. There is no principle of tax law or precept of tax administration that justifies denying a depreciation deduction because, in the past, the factual burden of proof could not have been sustained.

Consider an analogy from astronomy. In the 1600s, Galileo used a primitive telescope and observed what he believed to be satellites surrounding the planet Saturn. More sophisticated equipment, however, led over time to a series of other discoveries, each of which supplanted its precursor—first, that there was a single ring of a solid sheet of material, then a multitude of rings, and finally that there are actually seven rings, consisting of thousands of narrow ringlets, which themselves are made up of billions of pieces of ice. By utilizing increasingly powerful scientific instruments, astronomers have been able to discern that what was once thought to be a single, undifferentiated ring around Saturn in reality consists of billions of separate and distinct components.

Measurement and valuation techniques in respect of intangible assets have assuredly not been as long lived or dramatic as the scientific scrutiny of Saturn's rings, but there should be no mistake: the Third Circuit's analysis represents the legal equivalent of using Galileo's primitive telescope and insisting that customer-based intangibles are indistinguishable from goodwill notwithstanding the information available from Voyager space probes and the Hubble telescope.

Having chosen to ignore clear evidence of the depreciability of customer-based intangibles, the Third Circuit sought to rationalize its holding by differentiating between intangibles purchased in an acquisition and those purchased separately. (App. 17a.) The distinction, however, is without significance, for even though customer-based intangibles may be purchased as part of an acquisition of a business, they may also be purchased separately. Equally important, there is no legal or economic reason to condition depreciability on the terms of sale. As the Fifth Circuit observed in *Laird v. United States*, 556 F.2d 1224, 1234 (5th Cir. 1977), *cert. denied*, 434 U.S. 1014 (1978), "[i]t does not matter for purposes of amortization if individual assets only have economic significance in the context of an integrated transaction involving the sale of a number of assets." *Accord Citizens & Southern Corp.*, 91 T.C. at 492-93 ("[I]t is irrelevant for purposes of depreciation that deposit base cannot be separately transferred and only has economic significance in the context of a bank."). Stated differently, the view that depreciability must turn on factual bases "is more in accord with the realities of modern business technology in a day when lists are bartered and sold as discrete vendible assets." *Houston Chronicle*, 481 F.2d at 1253.[10]

To convert an inherently factual issue into a court-made legal decree always favoring the government is to nullify the longstanding and fundamental tax principle that

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[10] Nor is it dispositive that the subscriber relationship here at issue was terminable at will. Such a finding may affect the value of the intangible or its useful life, but it "does not as a matter of law prevent petitioner from factually showing that [the intangible] has an ascertainable cost basis separate and distinct from goodwill and that it has a reasonable ascertainable useful life." *Citizens & Southern Corp.*, 91 T.C. at 486 (discussing core deposit accounts). *See Super Food Servs. v. United States*, 416 F.2d 1236, 1240 (7th Cir. 1969) (it is immaterial that the contractual relationship may have no fixed termination date). As the Fifth Circuit rightly observed in *Houston Chronicle*, "[a]ll that the law and regulations require is reasonable accuracy in forecasting the asset's useful life." 481 F.2d at 1254. *See Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128, 139-41 (8th Cir. 1960) (Blackmun, J., concurring) (if the asset is shown to be a wasting one used in taxpayer's trade or business, a reasonable deduction must be allowed).

wasting assets are depreciable. The taxpayer here demonstrated that its paid subscribers were a wasting asset with a limited useful life and an ascertainable value separate and distinct from goodwill. That is all the Code and regulations require to entitle the taxpayer to a depreciation deduction.

II. THE RESIDUAL METHOD IS A VALID MEANS OF VALUING INTANGIBLES

The Third Circuit intimated that its holding may have been different if the taxpayer had used a different method for valuing the paid subscribers. (App. 30a.) In a somewhat murky fashion, the court seemed to reject the residual method of valuation used by the taxpayer here and to hold that in all events the taxpayer's deduction would be limited to the amount derived from using the cost method of valuation. (App. 28a-30a.) Such an analysis is seriously flawed and flouts Congress's express determination that the residual method is a legitimate means of valuing tangible and intangible assets.

Under the residual method, goodwill is essentially that which remains after all the other property—tangible and intangible—has been valued. Congress affirmed the validity of this method as recently as six years ago. In section 1060 of the Code, Congress mandated the use of the residual method of allocating the consideration paid among the assets—including intangible assets—conveyed in certain acquisitions.[11] The prescribed allocation method divides the purchase price into four components, with the last group being the repository for intangible assets in the nature of goodwill or going concern value. Thus, under the residual method, goodwill is what is left after all other allocations have been made. Temp. Reg. § 1.1060-

[11] Under section 1060 of the Code, the allocation must be made for purposes of determining both the seller's gain or loss with respect to the transaction and the buyer's basis in the assets received.

1T(d)(1) and (2). *Accord* I.R.C. § 338(a)(5); Temp. Reg. § 1.338(b)-2T(b) (requiring an identical method of allocating purchase price to assets following a stock purchase).

In adopting section 1060, Congress evinced the view that the residual method is a proper means of allocating the purchase price among the assets in an acquisition. *See* Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 358-59 (1987). Congressional endorsement of the residual method of valuation underscores the flawed nature of the Third Circuit's logic.[12]

III. THE THIRD CIRCUIT'S DECISION VIOLATES THE TAX LAW'S FUNDAMENTAL MATCHING PRINCIPLE

Ominously, the Third Circuit's opinion gives short shrift to a fundamental principle of the income tax system: the matching of income with associated expenses on an annual basis. The Internal Revenue Code imposes a tax based on *net* taxable income, *i.e.*, the amount remaining when a taxpayer's expenses are subtracted from its gross receipts. As this Court recognized earlier this term in *Indopco, Inc. v. Commissioner*, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." 60 U.S.L.W. at 4174 (citing *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974), and *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983)). The annual accounting system is a "practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals." *Hillsboro Nat'l Bank*

[12] The residual method is also embraced for purposes of computing the value of goodwill for financial reporting purposes. Accounting Principles Board Opinion No. 16, *Business Combinations*, and No. 17, *Intangible Assets* (August 1970).

v. Commissioner, 460 U.S. 370, 377 (1983) (citing *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931)). *See* I.R.C. § 446(b); Treas. Reg. § 1.446-1(a)(2) (requiring a taxpayer to adopt a method of accounting that clearly reflects income).

From the inception of the income tax, a taxpayer has been permitted to recover its capital costs through a deduction for depreciation. Surrey, *et al.*, *supra*, at 464. This Court has explained the depreciation deduction, as follows:

> [Depreciable] assets, employed from day to day in business, generally decrease in utility and value as they are used. It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets; hence it recognized that this decrease in value—depreciation—was a legitimate tax deduction as a business expense. It was the purpose of [the depreciation provisions] to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset.

Massey Motors, Inc. v. United States, 364 U.S. 92, 96 (1960). In other words, it is through the depreciation deduction that a taxpayer is able to recoup the true cost of an asset. *Cf. Idaho Power Co.*, 418 U.S. at 10. *See also* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 22 (1954) (Conference Report on Internal Revenue Code of 1954) ("Depreciation allowances are the method by which the capital invested in an asset is recovered tax-free over the years it is used in a business.").

The result mandated by the Third Circuit distorts the matching principle by effectively precluding taxpayers from recovering their costs. "Denying amortization deductions [for goodwill and similar intangibles] does not result in an accurate determination of taxable income since expenses are not properly matched to income generated." U.S. General Accounting Office, *Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets* (GAO/GGD-91-88) 5 (August 1991). To the extent a

depreciation deduction is denied, a taxpayer is taxed on other than its net income. The decision below would vitiate the statutory requirement to clearly reflect income.[13]

The Third Circuit's opinion is therefore wrong as a matter of sound tax policy.

IV. IT IS FOR CONGRESS TO DECIDE WHETHER THE TAX TREATMENT OF CUSTOMER-BASED INTANGIBLES SHOULD BE CHANGED

The Third Circuit's decision marks a radical departure in the legal principles to be employed in determining the depreciability of customer-based intangibles. *Amicus* TEI respectfully suggests that if the tax treatment of customer-based intangibles is to be so fundamentally changed, it is for Congress to decide. Contrary to the Third Circuit's assertion (App. 28a), Congress has not stood mute on this issue. Rather, it has specifically chosen not to act.

In 1987, the House of Representatives passed H.R. 3545 which included a provision that any amount paid or incurred to acquire customer base, market share, or any renewing or similar intangible item was to be treated as paid or incurred for intangible property with an indeterminate useful life, thereby rendering the customer-based intangible nondepreciable. *See* H.R. 3545, 100th Cong., 1st Sess. § 10120 (1987). The provision was not, however, included in the Senate version of the bill and was dropped during negotiations between the House and

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[13] The Third Circuit's decision is similarly contrary to the matching principle prescribed in governing financial reporting standards. For financial accounting purposes, taxpayers must record as assets the costs of acquired intangible assets and amortize the cost of each intangible over the period estimated to be benefited (not to exceed 40 years). Accounting Principles Board Opinion No. 17, *Intangible Assets* (August 1970); Financial Accounting Standards Board, Statement of Financial Standards No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions* (February 1983).

Senate conferees. H.R. Rep. No. 495, *supra*, at 937-38. In the Conference Report on the 1987 legislation, Congress acknowledged that "[a] substantial portion of the purchase price of a business is frequently allocated to certain intangible assets that represent the value of the existing customer base, and amortized over the period it is estimated that those customers may be lost." *Id.* at 937. It chose, however, *not* to alter that treatment. Legislation introduced since that time to limit depreciation deductions for intangible assets has similarly *not* been enacted. *See, e.g.*, H.R. 563, 102d Cong., 1st Sess. (1991). Indeed, earlier this year, the IRS supported and Congress enacted legislation to require the depreciation of intangibles—including goodwill—over a specific period of time. H.R. 4210, 102d Cong., 2d Sess. § 4501 (1992). The legislation, however, was vetoed by the President.

The depreciation of customer-based intangibles is not an area in which Congress has been passive and detached. Rather, it is an area in which Congress has explicitly demonstrated an awareness of the current law and has deliberately chosen not to amend it. Thus, even if the depreciation of intangibles somehow were found to violate fundamental tax law principles—and, in fact, it clearly does not—it is not for the Third Circuit to legislate a new rule. "If the [taxpayer] has found a hole in the tax dike, the problem must be corrected by applying the thumb of Congress, not the Court's." *Apple Computer, Inc. v. Commissioner*, 98 T.C. No. 18 (Dkt. No. 34127-87), at n.4 (1992), *reprinted in* [1992] Tax Ct. Rep. (CCH) 4759, 4762 n.4 (citing *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876, 879 (1st Cir. 1961)). *See also Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 367 (1931) (relief from allegedly burdensome statute afforded only by legislation, not the courts).

Moreover, Congress *has* focused on amending the tax treatment of other intangibles. Thus, in 1988, Congress enacted section 167(r) of the Code, which provided that no depreciation deduction is allowed with respect to any

trademark or trade name. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1002(i). This provision was repealed the next year. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7622(b)(1) (1989).

In other words, when Congress has deemed it appropriate to act on the tax treatment of intangibles, it has done so. *See Fabreeka Products*, 294 F.2d at 879 n.3 ("It may not be irrelevant to note that when Congress did amend the statute . . . it made a change in no way corresponding to what the government now proposes."). The legislature's specific refusal to disallow a deduction for customer-based intangibles should not now be overturned by judicial fiat.

CONCLUSION

For the foregoing reasons, the decision of the U.S. Court of Appeals for the Third Circuit should be reversed.

Respectfully submitted,

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